

DOW THEORY LETTERS INC.

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36 Letters per Year—\$60.00 Annually

Registered with the Securities Exchange Commission

November 12, 1969

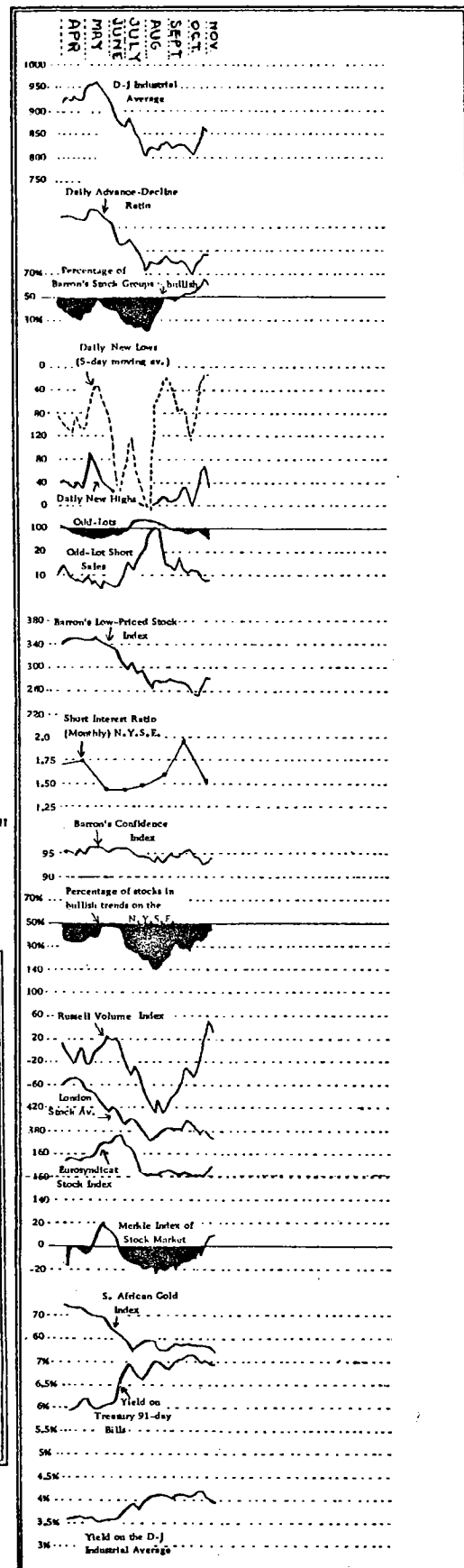
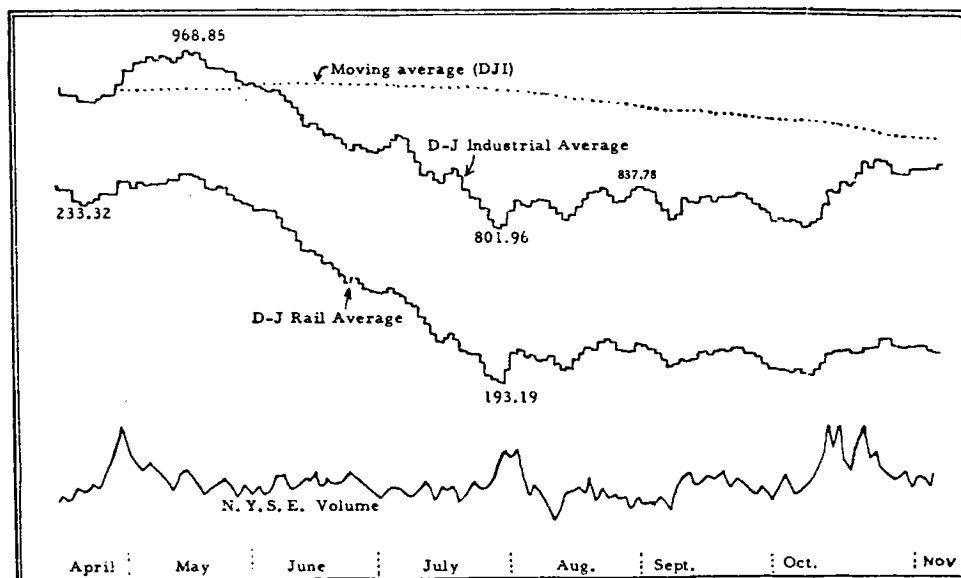
Letter 444

THE MARKET: I note that people are turning more and more towards the news of the day for signs that "the bear market is over." Every development, large or small, is seized upon as a reason for the stock market to do this or that. "President Nixon's speech will clear the air," or "the Fed will ease up and send the market skyward," or "the international monetary picture will settle, thus giving the market new impetus." My only reply is rubbish. The primary trend or tidal force of the market does not operate on news events anymore than a patient suffering from an incurable heart disease operates on adrenalin shots.

On February 9, 1966, the primary bull market discounted the best that could be seen ahead. On that day the D-J Industrial and Rail Averages recorded their last highs. From then on, the market was in the hands of the bear forces. Not a man alive (assuming he even believed in the primary bear market) knew how the bear forces would express themselves. No man knew whether the market would collapse, wither away, tumble then rally or simply descend into an increasing maelstrom.

What happened after February, 1966, was as unexpected as it was unpredictable. From a low of 744.32 in October, 1966, the market embarked on a boiling, speculative recovery which by late 1968 took Industrials to within 10 points of the 1966 bull market high. Then, amid a background of rampant inflation, the market began sinking. By mid-1969 the Dow was teetering on the edge of the 800 level, while a large portion of the nation's equities lay in shambles.

Inexplicably, the 800 level became the widely-touted "one yard line." After testing that level four times (while alternately rallying to the 840 area) the Dow finally broke out to an October 24 peak of 862.26. Then the "normal and expected" correction occurred, taking the Dow back to the 840's again.



Page 2 A few Letters back I warned subscribers against allowing their emotions to rule them in their appraisal of the market. Of course everyone wants a return of the 1949 to 1966 bull market. Of course good news "sounds" as if it should propell the Averages skyward, just as it so often did during the late bull market. But primary bear markets do not work like bull markets. Good news and rallies during bear markets are the investor's worst enemy. Why? Because they build up false hopes, and they bring the believers back into equities again and again. But as long as the bear market is on, every rally ultimately turns into a trap, an enticement which fizzes and leaves only losses in its wake. Just as declines and reactions during a bull market serve to shake out the amateurs, thereby keeping the bull market technically strong, so rallies in a bear market serve to transfer stocks from strong hand to weak, and thus prepare the way for the next collapse.

It should be remembered that the great majority of bear market smashes start with little or no news or fanfare. The market, seemingly without "justification," just turns down and starts coming unraveled. Because there is no news, people tend to hold onto their stocks. But as the decline gathers momentum, the price movement itself brings on first anxiety, then consternation and finally panic.

In my opinion, the market will support no more "tests" of the 800 level. If the current rally fails, if the Dow once more heads for 800 it will drift through that level as if it never existed. Because so much has been made of the magical 800 level, I would guess that any forthcoming penetration of 800 will bring in a large amount of selling (and particularly dumping by those speculators who have purchased stock for the current rally). A month ago Wall Street was braced and prepared for a violation of 800. If it occurs now, it will wipe out all hopes for action above 800—and have moved thousands of new customers to the loss side of the ledger.

One of the amazing things about the entire current situation is that so few people, both amateur and professional, give any credence at all to the primary trend. I have stated over and over again my reasons for believing that we are in a primary bear market. Yet the latest tabulation shows that fully half the investment services are now bullish. Investment services tend to be written and edited by professionals. If half the services are now bullish, what percentage of the public must believe that "things are basically all right"?

Yet it is crucial to understand that all these people are assuming a bullish stance within a primary bear market. Remember what happened during the 1949-1966 bull market when investment services and the public turned bearish. Time and time again these bears were squeezed out of the short side of the market or left behind as (following each reaction) the primary bull trend took the market to new highs. If I am correct, if there is currently a primary bear market in progress, then the situation becomes most dangerous when an increasing number of people become hopeful, optimistic or outright bullish.

It is just at such times that a bear market suddenly may crumble, literally fall away as the primary trend reasserts itself and prices catch up on the downside. Just as during a bull market the longer the downward correction (against the primary trend) the more violent the inevitable rush to new highs, during a bear market the longer the holding or rallying action the more violent the decline when the primary bear forces finally reassert themselves.

That, in a nutshell, is why I see the situation as so dangerous at this time. It has been slightly over three years since the bear market recorded its last lows (October, 1966 to be exact). This is a very long time for the primary trend to be held back or interrupted. And this is the reason why I believe that the coming decline is fated to be so costly. There is a good probability that the severity of the next decline will be directly proportional to the duration and extent to which the bear forces have been denied expression.

In the seven months of drastic downside action ending on July 31, 1969, almost all the stock purchases of the past two years were turned into losses. I submit that two weeks of real, bear market action during the period ahead could easily turn all the purchases of 1969 into losses. Those buying stocks now must realize that they have purchased equities during a period which is fraught with danger. During a primary bear market the odds always favor the establishment of losses rather than gains. As I see it, this is particularly true at the current time when the market has already put three months of rallying action behind it and when the bank credit picture (see later section) is, as expert Donald Storey put it, ".....as bad as, or worse than any time since 1929."

SHORT TERM: Subscribers will remember that the August peak for Rails was 202.02. That was the point which the carriers had to better in order to confirm the Industrials. On October 28 the Rails pushed to 202.45, but this "one-day wonder" confirmation was short-lived. The Rails immediately dipped below the August peak, and since then they have floundered or trended slightly lower. On November 6 the Rail Average sank below the 200 level again, despite Industrial strength. I would say that unless the Rails can get "in gear" with the Industrial Average on the upside, the implications are that this rally is living on borrowed time.



ONWARD BUT TO WHERE? The accompanying chart, drawn to semi-logarithmic or percentage proportions, shows the end-of-the-month closing prices for the D-J Industrials and Rails from 1962 to date. According to orthodox Dow Theory, an advance terminates at the point where the two Averages register their last confirmed highs. The last confirmed highs of the D-J Industrial and Rail Averages were recorded on February 9, 1966, at 995.15 for Industrials and 271.72 for Rails. In the almost-four years since then, Rails have pushed to two successive new peaks (see chart) but Industrials refused on both occasions to confirm. Thus we have a bull market top in February, 1966 which continues to stand, unchallenged, as the termination point of the 1949-1966 bull market.

The first primary bear market leg extended from 995.15 (February, 1966) to 744.32 (October, 1966), a total loss of 251 points for Industrials. The recovery began at the 744.32 low of October, 1966, and continued to 985.21, a distance of 241 points.

The ability of the market to hold following a recovery is very important. In strong markets, the Averages will tend to hold at least half of their recovery gain during a reaction. Conversely, declines which tend to wipe out substantially more than

The 1969 decline was the first major decline following the 1966 to 1968 recovery. The 1969 decline for Industrials ran from 985.21 to 801.96, a distance of 184 points. In percentages, the 1969 decline erased 76% of all the Industrial gains since the 1966 lows. This was a poor performance, one that indicated a weak market structure.

For the Rails, the performance was considerably worse. The 1969 decline wiped out 92% of the entire 1966-1968 recovery phase. In fact, Rails missed breaking the 1966 low point by a narrow margin of only 9 points.

The secondary lows for the bear market were established on July 31, 1969 at 801.96 for Industrials and 193.19 for Rails. The Averages have been moving above those lows for a period of three months. The big question is....what did the lows of 801.96 and 193.19 represent? Were they temporary lows, lows formed preparatory to the next major plunge, or were they basing points for a new bull market or at least basing points for another attack on the 1968 highs?

With margin accounts declining but still high, with a huge drop in the September-October total short interest, with speculative interest still very high, with important investment groups like oils dropping to new lows for the year, with the monetary and bank credit factors highly unfavorable, with the bond-stock yield at its most adverse spread in history, I continue to take the view that no bear market bottom has been seen, either during 1966 or during 1969.

The Averages may continue to fluctuate between the 1968 highs and the 1969 lows, but my own feeling is that the next major move is going to be down through the 1969 and then the 1966 lows. The forces of the primary bear market will ultimately express themselves to the full—but in their own good time and not at our convenience.

CLOSER TO THE EDGE: The coming great dilemma draws closer. Beryl Sprinkel, a leading Chicago economist (he is economist for the Harris Trust and Savings Bank) and noted author states that we are now in the "economic pause" preceding the tumble. I agree with him. Sprinkel points to industrial production which has flattened out, unemployment which is moving up, housing starts which are in a bearish trend and corporate profits which he thinks may drop 25% to 30% next year unless economic restraint policies are reversed.

Turning to another noted economist, Donald Storey of the authoritative Bank Credit Analyst, Mr. Storey, in his latest report notes that each successive economic slowdown has required greater infusions of bank credit to bring the economy back into an expansionary phase again. For instance, in 1967 we not only had a massive Government deficit, but it required more than \$40 billion in bank credit (a rise in bank credit at the rate of 14% annually) to push the economy up again.

But, notes Storey ".....successive downturns were never permitted to become deep enough to correct liquidity ratios back to those prevailing earlier. It is this long-term one-way decline in liquidity that has brought the credit structure close to the point of destructive instability."

The fact is that the next slowdown would require practically unprecedented infusions of bank credit to keep the nation from slumping into recession. And such expansionary policies, ironically, would have to be adopted while the forces of inflation are still rampant (as they now are).

In the latest issue of Fortune magazine, the picture is put in stark terms: "When the time comes for those who make U.S. monetary policy to move from restraint towards ease they will come face to face with the grim visage of the U.S. balance of payments. On the broad 'liquidity basis', the U.S. balance-of-payments deficit was running at the fantastic annual rate of \$15 billion last spring. The rate has come down since, but the deficit for the full year threatens to exceed \$10 billion—more than the combined deficits for the past five years."

Thus the dilemma is that with leading liquidity ratios at severe "danger levels," with inflation still ravaging, with towering deficits, the economy is slowly producing signs of a slowdown which should become far more evident in 1970—unless the floodgates of credit are again opened wide. The financial world seems to be hardly aware of the possibility of shock in late-1969 or 1970. Yet, as Mr. Storey states, "The economy is less equipped to withstand shock than it has been in 40 years."

One gauge of the financial "temperature" is the velocity of turnover of demand deposits in New York, the nation's financial center. I am hereby up-dating a chart (page 5) which was last presented in Letter 404. The latest figures show that the velocity of demand deposit turnover in New York during October was 153.6, just short of the October, 1929 record of 156. This means that demand deposits or checking account money are turning over at white-heat rapidity in New York, or about three times a week. Such a frantic rate was reached only once before, and it was not sustained then. In effect, the velocity of turnover is reaching the point of no return.(chart and statistics courtesy of the Bank Credit Analyst).

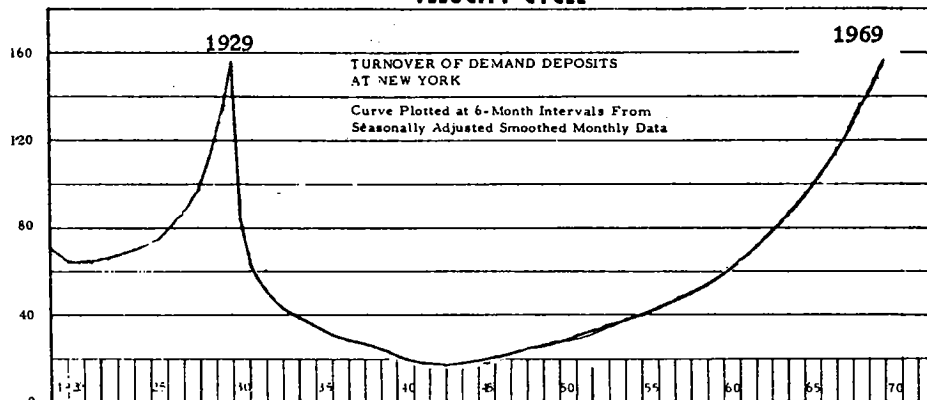
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I am indebted to my friend Irving Weiss (Capital Advisors, Inc.) for another glimpse into what is now happening. The chart marked "1" shows that corporate sales in relations to each dollar of debt are declining, with by far the worst position being assumed by the giant manufacturers. One of the reasons for the more ominous showing by the giants is that the smaller manufacturers have simply not been able to obtain money (debt) during the past few years. The second chart (marked "2") shows the collapse of liquidity as the ratio of current assets to all debt plunges. Here again, the small manufacturers have kept a better liquidity ratio than the giants, and probably for the same reason given above.

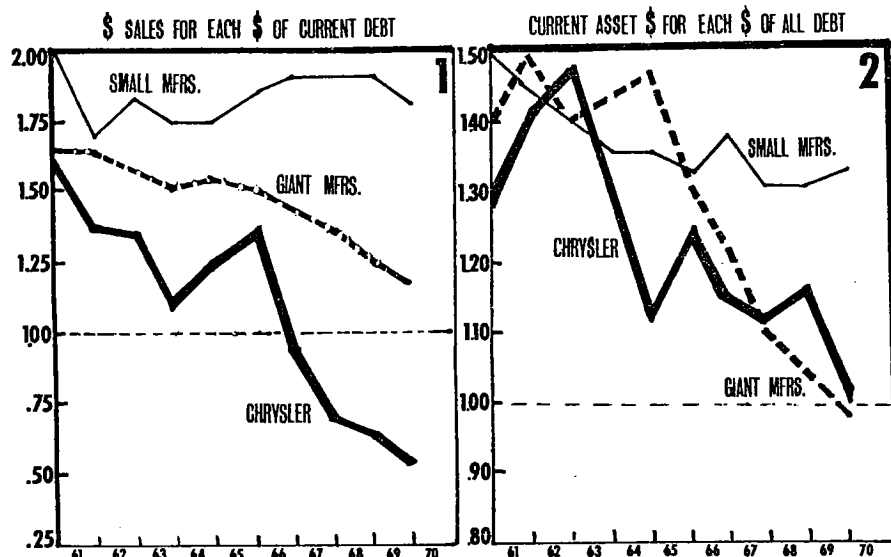
The heavy line on the chart depicts the particularly difficult straits of Chrysler in relation to these two charts. When sales drop even slightly in the face of mounting debt expenses, profits slide, and this is what occurred in Chrysler. As noted in a previous Letter, Chrysler's third-quarter 1969 profits dropped 87%. These charts show why. They also give indication of what may occur ahead when and if the total sales of other giant manufacturers begin to decline. Debt in the face of rising sales is seldom a problem, but a precarious debt structure in the face of sinking corporate sales is the prescription for disaster.

As a final warning, I include a chart put out by the St. Louis Federal Reserve Bank illustrating the trend of outstanding Certificates of Deposit and Commercial Paper. With Regulation Q limiting bank C/D's to a top rate of 6.25% in interest, it is obvious from the chart that C/D's have been running off at a very rapid rate. Commercial Paper has taken the place of C/D's, and of course commercial paper is issued by corporations at a price which is, of necessity, in line with prevailing short-term interest rates. Most prime commercial paper is now issued at around 8.5% to 9%. But now a bill is before the Senate requesting that commercial bank

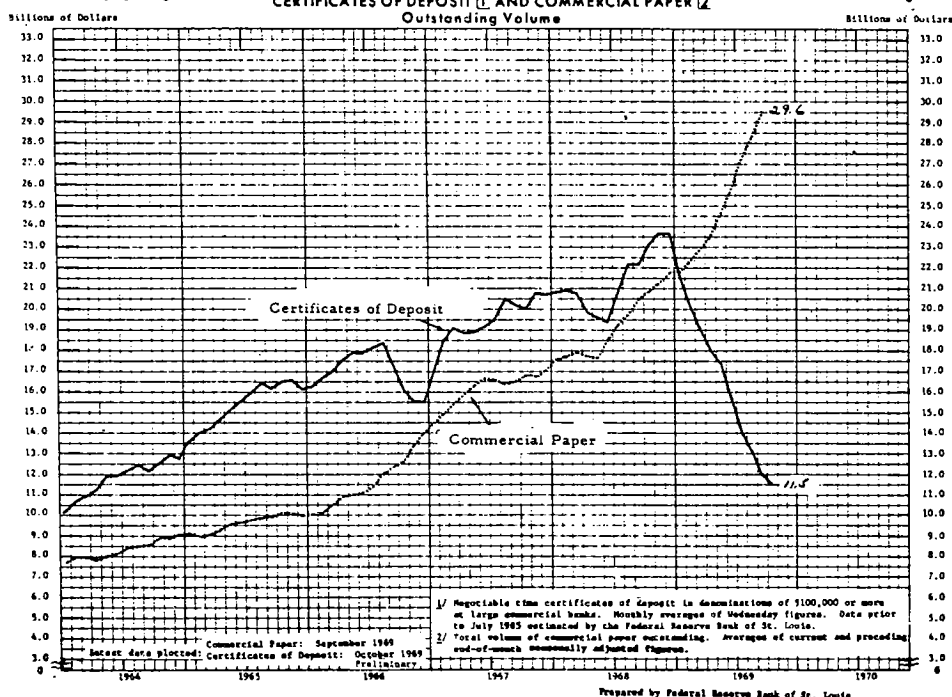
VELOCITY CYCLE



SQUEEZE ON BUSINESS



CERTIFICATES OF DEPOSIT (1) AND COMMERCIAL PAPER (2)



paper be subject to Regulation Q, and this would mean the 6.25% rate. If this occurs, it will mean that banks will not be able to sell their paper in the market. They will be priced out of business.

There is currently about \$30 billion of commercial paper outstanding or five times that of 1962. This figure can be appreciated when it is realized that the amount of commercial paper outstanding is almost half the amount of commercial loans outstanding in all the nation's leading commercial banks. In other words, if bank commercial paper is placed under regulation Q as now seems probable, a gigantic new credit squeeze will be brought into effect.

So there it is, a once-in-a-generation dilemma which few are aware of, fewer understand, and which is rapidly building to a climax. The picture is clear on one count: As business levels off or declines, corporate profits will tumble. To offset this, the Fed will have to face the problem of injecting massive infusions of bank credit into the economy in order to push business into another expanding phase. But a reversal from the current monetary and fiscal squeeze to one of monetary and fiscal expansion would set off waves of inflation which would be totally disastrous. The drama lies ahead, probably in 1970. It is a drama which is hardly calculated to be pleasant. In the meantime, the current short-term and intermediate movements of the stock market, in the face of the picture building ahead, are little more than meaningless.

CHARTS OF THE TIMES: I include three charts which offer valuable insights into what is occurring in the economy. The first shows the collapse in net savings at savings & loan institutions. The chart shows the net increase for 1969 approaching the zero mark. The second chart shows what is happening to construction contracts, and a portion of this is due to the drop in savings. The third chart shows the waning demand for capital goods, with volume of shipments now surpassing the value of new orders. A continuance of this trend, obviously, will mean a forthcoming decline in shipments. New orders for capital goods, by the way, is one of the factors which make for booms or recessions.

FAR EASTERN COMMENT: A subscriber from Hong Kong just sent me this clip from a brokerage ad in (would you believe) the "South China Morning Post." The East still possesses plenty of wisdom as those who read this may admit.

The market is a living thing, following its own course, and it cannot be influenced by wishful thinking. Even though our reasoning may seem correct from an objective viewpoint, we cannot always be sure whether the market will react in the way we want it to.

Once the price has hit the ceiling, it cannot go higher, even though prospects may seem brighter. Likewise, once a price has reached rock-bottom, it cannot go lower even though many unfavourable factors may still persist in the market.

Therefore, we must seek the right answer in the market itself: we can miss a great chance by holding on to our own viewpoint and thus overlooking the general market trend. We can, then, hardly blame our failure on the market.

(A lesson from an old Japanese market proverb)

